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# In the Supreme Court of the United States

OCTOBER TERM, 1974

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BLUE CHIP STAMPS, ET AL., PETITIONERS

*v.*

MANOR DRUG STORES, ETC.

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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### QUESTION PRESENTED

The Commission will discuss the first question presented: Whether a party who neither purchased nor sold securities has standing to seek damages for injuries caused it by a violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

## INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Commission is primarily responsible for the administration and enforcement of the federal securities laws, including the Securities Exchange Act of 1934. Private actions by the victims of securities frauds, however, are a "necessary supplement" to the Commission's enforcement activities. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. The Commission opposes restrictive constructions of the securities laws and of the Commission's rules that would weaken the protections they afford investors. Accordingly, the Commission as *amicus curiae* in private actions has argued consistently that the right to recover damages for violations of the broad antifraud provisions of Rule 10b-5, authorized by Section 10(b) of the Securities Exchange Act, should not be limited to actual purchasers and sellers of securities but should extend to all investors and potential investors injured by violations of the Rule.

## STATEMENT

In December 1963 the United States filed a civil antitrust action against Blue Chip Stamp Co. and nine of its twelve stockholders.[1] The complaint charged that the defendants had conspired to restrain and had

[1] This statement of facts is taken from the opinion of the court of appeals and from the complaint filed by Manor Drug Stores. Because the district court granted petitioners' motion to dismiss the complaint, its factual allegations must be accepted as correct. *Conley* v. *Gibson*, 355 U.S. 41.



monopolized the trading stamp business in California. In addition to Blue Chip Stamp Co., the defendants were major California retailers who used Blue Chip stamps and who collectively owned 90 percent of Blue Chip Stamp Co. stock. The suit was settled in 1967 by a consent judgment. See *United States* v. *Blue Chip Stamp Co.*, 272 F. Supp. 432 (C.D. Calif.).

The judgment provided that Blue Chip Stamp Co. would be merged into a new corporation, Blue Chip Stamps. Securities of the new corporation were to be offered, at "bargain" prices, to retail firms—including Manor Drug Stores, the plaintiff in this action—that had used Blue Chip stamps but had not owned stock in Blue Chip Stamp Co. Each of these retail firms was entitled to purchase securities in proportion to the amount of stamps it had used. The complaint of respondent Manor Drug Stores alleges that the securities were offered at a bargain in order to allow the users to share in the undistributed profits of Blue Chip Stamp Co. (App. 10-11).

The complaint charges that the defendants (now petitioners) devised a scheme to dissuade the offerees, by means of misleading statements, from purchasing the securities. The apparent motivation for the scheme was that any securities not purchased in the "bargain" offer could be sold later on the open market by petitioners at a greater price, thereby increasing the assets of Blue Chip Stamps and the value of each share owned by the other petitioners. Alternatively, the shares not sold in the offering could be retained by Blue Chip Stamps and the shareholders of

Blue Chip Stamps could "retain" the undistributed profits that would have been distributed by the "bargain" sale.[2]

In order to discourage the offerees from purchasing the securities, petitioners unduly emphasized in the prospectus (App. 55-90) certain "Items of Special Interest" that might adversely affect the value of the securities; the prospectus also contained inflated estimates of anticipated expenses. Because of these misleading representations certain offerees did not purchase the securities and, therefore, did not receive the intended "bargain."[3]

The district court dismissed the complaint on the basis of the "*Birnbaum* rule," attributed to *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (C.A. 2), certiorari denied, 343 U.S. 956, which states that a person who is neither a purchaser nor a seller of securities may not bring an action under Section 10 (b) of the Securities Exchange Act of 1934 or Rule 10b-5 thereunder.

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[2] As petitioners noted (Br. 7, n. 6), the plan of reorganization did not call specifically for public sale of the unsold shares. The plan, however, forbade petitioners from owning more than 43 percent of Blue Chip Stamps and, if some of the users decided not to purchase the shares offered, petitioners would have to sell either the unpurchased shares or their own shares in order to reduce their holdings to this proportion. In either event the asset value per share would be greater for petitioners if the users failed to purchase their allotments.

[3] Although the offering price of the new securities was $101, the market value was alleged to be $315 at that time (App. 11).



Respondents appealed, but before the appeal was decided another panel of the Ninth Circuit, in *Mount Clemens Industries, Inc.* v. *Bell*, 464 F. 2d 339, adopted the *Birnbaum* rule. A divided panel in the instant case accepted *Birnbaum* and *Mount Clemens* as controlling, but reversed on the ground that those cases did not involve a situation where the plaintiffs had a right to buy securities "at a fixed price and in a fixed amount" (App. 141). The court held that the offering of securities in this case, in compliance with the antitrust decree, "served the same function as" a contract for the purchase or sale of securities and therefore supported a damages remedy for the non-buying plaintiff class (App. 141, 155).

## SUMMARY OF ARGUMENT

Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to Section 10 (b), provide that it is unlawful to use deceptive devices or make misleading statements "in connection with the purchase or sale of any security." In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (C.A. 2), certiorari denied, 343 U.S. 956, the Second Circuit held that under the Act and Rule only individuals who had purchased or sold securities could bring actions to seek redress for a violation.

The proscriptions under Section 10(b) and Rule 10b-5 "are broad and, * * * are obviously meant to be inclusive." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151. Accordingly, a violation of Section 10(b) and Rule 10b-5 repeatedly has been held not to depend upon proof of an actual purchase or sale of a security, and includes deceptive activity that affects an investment decision not to buy or sell a security no less than a decision to do the contrary. Even the dissenting opinion in the court below does not question that a violation of Rule 10b-5 has been alleged in this case.

The *Birnbaum* rule has nevertheless survived as an essentially arbitrary principle of "standing"—that a victim of a violation may bring an action for damages only if he is the purchaser or seller of securities —although the courts applying the rule disagree as to its precise scope and as to exceptions that may be available. The *Birnbaum* limitation is inconsistent with this Court's repeated recognition that persons within the class a statute is designed to protect, and who have been injured by a violation of that statute, have standing to seek relief for injuries they have suffered. See, *e.g.*, *Wyandotte Transportation Co.* v. *United States*, 389 U.S. 191. This principle has been applied generally under the Securities Exchange Act, see *J. I. Case Co.* v. *Borak*, 377 U.S. 426, and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, and specifically under Rule 10b-5, *Superintendent of Insurance* v.



*Bankers Life & Casualty Co.*, 404 U.S. 6, and *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128.

Consistent with this principle, courts of appeals that have applied the *Birnbaum* doctrine to damage actions have nevertheless permitted private suits for equitable relief with respect to violations of Rule 10b-5. But as this Court recognized in *Borak*, *supra*, and *Mills*, *supra*, with respect to similar antifraud rules relating to proxy solicitation, the remedial objectives of the Securities Exchange Act require that a private action for damages also be recognized.

To the extent the *Birnbaum* rule serves any purpose, it acts as a device to limit the class of potential plaintiffs, and thus, as petitioners point out, may ameliorate the possibility of strike suits and "calamitous" damage judgments. But the arbitrary denial of standing to individuals who are not purchasers or sellers of securities but have suffered demonstrable loss because of a violation of the Act is contrary to the purposes of the securities laws and unjustified. The public policy of preventing unwarranted damage awards could be achieved through requirements (in appropriate cases) of stricter standards of proof or the limitation of vicarious liability.

## ARGUMENT

### THE VICTIM OF DECEPTIVE ACTIVITIES IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES SHOULD BE ABLE TO RECOVER HIS DEMONSTRABLE DAMAGES WHETHER OR NOT HE HAS PURCHASED OR SOLD SECURITIES

In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (C.A. 2), certiorari denied, 343 U.S. 956, the Second Circuit discussed the understanding it then had of the purpose of Section 10(b) and Rule 10b-5. It stated that the Rule is directed "only at 'a fraud perpetrated upon the purchaser or seller' of securities," *id.* at 463, and that, accordingly, the Rule "extended protection only to the defrauded purchaser or seller."[4] *Id.* at 464. This narrow reading of Rule

[4] The plaintiff in *Birnbaum* was a shareholder in a corporation contemplating an advantageous merger with another firm. The controlling shareholder in the corporation in which plaintiff held securities elected to sell his shares, at a substantial control premium, to a third corporation. As a result of this sale of control the possibilities for merger were foregone, and plaintiff did not reap the advantages that merger would have brought him. He sued the controlling shareholder and the acquiring corporation; the court of appeals affirmed a dismissal of the action, stating that the Rule was not intended to protect the stockholders of a corporation against a breach of fiduciary duties by corporate insiders. *Id.* at 464. If no more were involved in *Birnbaum*, the case would not be troublesome. This Court has subsequently agreed that the statute does not regulate transactions that constitute no more than internal corporate mismanagement. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12.



10b-5—principally based on the court's narrow reading of Section 10(b)—has not been followed.

The "*Birnbaum* rule" has become a principle of "standing," rather than an interpretation directed to any limitation on the scope of the Act's and Rule's prohibitions—that is, despite allegations of a clear violation of Section 10(b) and Rule 10b-5 that have resulted in injury, if the injured person did not purchase or sell the securities he may not bring an action to recover his damages.[5]

[5] Most courts of appeals have accepted the *Birnbaum* rule, although the courts disagree about the scope of the doctrine and the exceptions available to avoid its application. See, *e.g.*, *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (C.A. 2), certiorari denied, 399 U.S. 909; *Landy* v. *Federal Deposit Insurance Corp.*, 486 F.2d 139 (C.A. 3), certiorari denied, 416 U.S. 960; *Sargent* v. *Genesco, Inc.*, 492 F.2d 750 (C.A. 5); *Smallwood* v. *Pearl Brewing Corp.*, 489 F.2d 579 (C.A. 5); *City National Bank* v. *Vanderboom*, 422 F.2d 221 (C.A. 8), certiorari denied, 399 U.S. 905; *Simmons* v. *Wolfson*, 428 F.2d 455 (C.A. 6), certiorari denied, 400 U.S. 999; *cf. Kerbs* v. *Fall River Industries, Inc.*, 502 F.2d 731, 738-740 (C.A. 10); *International Controls Corp.* v. *Vesco*, 490 F.2d 1334 (C.A. 2), certiorari denied, 417 U.S. 932; *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (C.A. 5), certiorari denied, 365 U.S. 814; *James* v. *Gerber Products Co.*, 483 F.2d 944 (C.A. 6).

The Seventh Circuit has rejected *Birnbaum*. See *Eason* v. *General Motors Acceptance Corp.*, 490 F.2d 654, certiorari denied, 416 U.S. 960. Several district courts recently have disavowed the *Birnbaum* rule as inconsistent with the prevailing interpretation of Rule 10b-5. See *Young* v. *Seaboard Corp.*, 360 F. Supp. 490 (D. Utah); *Tully* v. *Mott Supermarkets, Inc.*, 337 F. Supp. 834 (D.N.J.). (*Landy* v. *Federal Deposit Insurance Corp.*, *supra*, 486 F.2d at 156, n. 10, apparently limits *Tully* to requests for injunctive relief.) And several district courts have held that there may be a private

### A. Section 10(b) and Rule 10b-5 Protect "Any Person" Against Deceptive Devices Material To An Investment Decision

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), provides that it is unlawful for any person to use, "in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance" in contravention of the Commission's rules. In *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151, this Court stated that Rule 10b-5(c) prohibits "any act, practice or course of business which operates or would operate as a fraud or deceit upon any person * * *," and held that the proscriptions under Section 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." Similarly, *Superintendent of Insurance*, *supra*, 404 U.S. at 11, n. 7, held that Section "10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, * * *."[6] As the court below recognized prior to the instant case:[7]

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action by an investor who, in violation of the rule, has been misled not to sell his securities. See, *e.g.*, *Commerce Reporting Co.* v. *Puretec, Inc.*, 290 F. Supp. 715, 718-719 (S.D. N.Y.); *Opper* v. *Hancock Securities Corp.*, 367 F.2d 157 (C.A. 2), affirming 250 F. Supp. 668 (S.D.N.Y.); *Goodman* v. *H. Hentz & Co.*, 265 F. Supp. 440, 443-445 (N.D. Ill.); *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215, 213-219 (S.D.N.Y.); *M. L. Lee & Co.* v. *American Cardboard & Packaging Corp.*, 36 F.R.D. 27, 30-31 (E.D. Pa.).

[6] Emphasis in original. This Court was quoting from *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (C.A. 2).

[7] *Ellis* v. *Carter*, 291 F.2d 270, 274 (C.A. 9), dismissal affirmed, 328 F.2d 573. Accord, *Rekant* v. *Desser*, 425 F.2d



> It would have been difficult to frame the authority to prescribe regulations in broader terms. * * * We see no reason to go beyond the plain meaning of the word "any", indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden * * *.

Even the court of appeals that decided *Birnbaum* has subsequently stated that the broad language of Rule 10b-5 "demonstrates that the SEC sought by the Rule * * * fully to implement the Congressional purpose and objectives underlying Section 10(b)."[8] And, as one commentator wrote, the Section and Rule contain what is "plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction."[9]

Petitioners assert (Pet. Br. 31) that the language of Rule 10b-5 and Section 10(b), by "limiting" their coverage to matters "in connection with the purchase

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872, 880 n.15 (C.A. 5); see also *McClure* v. *Borne Chemical Co.*, 292 F.2d 824, 834 (C.A. 3), certiorari denied, 368 U.S. 939.

[8] *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (C.A. 2) (*en banc*), certiorari denied *sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976.

The House Committee appraised the function of the Securities Exchange Act as an undertaking to advance the law by a "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting' * * *." H. Rep. No. 1383, 73d Cong., 2d Sess. 5.

[9] Bromberg, *Securities Law: Fraud—SEC Rule 10b-5*, Sec. 7.6(1), p. 190.21 (1973).

or sale of any security," "does not include an *offer* to purchase or sell" (petitioners' emphasis). They conclude: "Had Congress intended section 10(b) to reach offers, it knew how to accomplish that purpose." But Section 17(a) of the Securities Act, upon which the language of Rule 10b-5 is based, expressly and unambiguously proscribes fraud "in the offer" as well as fraud "in the * * * sale of any securities * * *." As the petitioners themselves recognize (Pet. Br. 18-19), Rule 10b-5 was adopted to extend to "all purchasers of securities" the same "prohibitions on fraud" that Section 17(a) imposed upon sellers.[10] Although Section 17(a) of the Securities Act relates only to

[10] Even if Rule 10b-5 were limited in application as the petitioners suggest, the plaintiff's only error in the district court was in failing to allege a cause of action predicated upon Section 17(a) of the Securities Act as well as one under Rule 10b-5.

The complaint must be read in the light most favorable to the plaintiff, recognizing that any ambiguities or omissions in the pleadings should be resolved in favor of the plaintiff, since any such deficiencies in the complaint can be cured by amendment, see *Lanasa Fruit S. S. & I. Co.* v. *Universal Insurance Co.*, 302 U.S. 556, 559. For the same reasons that a cause of action is recognized under Rule 10b-5, it must be recognized under Section 17(a). This would cure the deficiency that the petitioners perceive—although some courts, disregarding even the unambiguous expression of congressional purpose, have applied the *Birnbaum* doctrine to actions brought under Section 17(a) as well as under Rule 10b-5. See, *e.g.*, *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385, 396 (S.D. N.Y.), affirmed, 405 F.2d 200 (C.A. 2), reversed in part on other grounds, 405 F.2d 215 (*en banc*), certiorari denied *sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906; *Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783, 790-791 (C.A. 8); *Simmons* v. *Wolfson, supra*, 428 F.2d 455.



fraudulent activity "in" the offer or sale of securities, the broader statutory language "in connection with" used in Section 10(b) and Rule 10b-5 (which relates to all deceptive activities "touching" securities transactions, *Superintendent of Insurance, supra*, 404 U.S. at 12) made it unnecessary to include the word "offer" in those provisions. Cf. *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 197-199.

There can be no doubt under the Act, Rule, and controlling decisions of this Court, that, if the allegations of respondent's complaint are true, prohibited deceptive statements have been made. This conclusion is supported by the legislative history of the statute. The Securities Exchange Act of 1934 was enacted in response to "the speculative orgy of 1928 and 1929" [11] and a presidental call for securities "legislation [that] has teeth in it." [12] Congress, recognized that "[s]peculation, manipulation, * * * investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries" were "all a single seamless web," [13] and that an act designed to purge all avenues of abuse would require broad remedial provisions. Thus, the Act was intended to cover "a wide field." [14]

Congress understood, however, that it could not, by specifying or cataloguing particular forms of unlaw-

[11] S. Rep. No. 1455, 73d Cong., 2d Sess. 81.

[12] H. Rep. No. 1383, 73d Cong., 2d Sess. 2.

[13] H. Rep. No. 1383, 73d Cong., 2d Sess. 6.

[14] *Ibid.*

ful conduct, itself effectively prohibit all forms of practices that "for some purposes may be turned to illegitimate and fraudulent means." [15] Accordingly, it vested "broad discretionary powers in the [Securities and Exchange Commission]." [16] See generally *Superintendent of Insurance, supra.*

Section 10(b) creates such discretionary power by authorizing the Commission by rule and regulation to proscribe manipulative or deceptive practices in connection with the purchase or sale of any security. As one of the draftmen described an earlier version (then Section 9(c)) before the House Committee, the section provided, in effect:

> "Thou shalt not devise any other cunning devices." * * * [S]ubsection (c) is a catch-all clause to prevent manipulative devices. * * * The Commission should have the authority to deal with new manipulative devices.[17]

The Senate bill, from which most of Section 10(b) was taken verbatim,[18] went further; it gave the Commission broad rulemaking authority with respect to deceptive as well as manipulative practices. Although

[15] *Id.* at 7.

[16] *Ibid.*; see also 78 Cong. Rec. 7696 (remarks of Rep. Rayburn). The Senate Committee viewed the Securities Act of 1933 and the Securities Exchange Act of 1934 as vesting "in the Securities and Exchange Commission jurisdiction over the source of and traffic in securities." S. Rep. No. 1455, 73d Cong., 2d Sess. 393.

[17] Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720, 73d Cong., 2d Sess. 115.

[18] H. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 32-33.



representatives of the securities industry had complained that these provisions would give the Commission power to prohibit virtually anything,[19] the Conference Committee broadened the language of the section still further.

The Senate bill would have authorized rulemaking with respect to practices "detrimental to the interests of the investor," but the Committee expanded the authority to cover rulemaking "necessary or appropriate in the public interest" as well as "for the protection of investors." [20] After considering these alternatives, Congress agreed upon the present language, which gives the Commission broad rulemaking power to prohibit "any manipulative or deceptive device or contrivance," and omitted language that would have confined the section solely to securities traded or listed on a national securities exchange.[21]

[19] Hearings on H.R. 7852 and 8720, *supra*, n. 17, at 178, 208-209, 251, 258, 297, 305, 486; Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.), Part 15, 73d Cong., 1st Sess. 6624-6625, 6634, 6899, 6910, 6936-6938, 6988.

[20] H. Conf. Rep. No. 1838, *supra*, at 32-33. Cf. *A.T. Brod & Co.* v. *Perlow*, *supra*, 375 F.2d at 396:

> These rules and regulations [under Section 10(b)] were to be promulgated by the Commission "*in the public interest or* for the protection of investors." * * * Rule 10b-5 * * * was designed to protect both investors *and* 'the public interest.' [Emphasis in original.]

[21] See S. 3420, Section 10(b), 73d Cong., 2d Sess. (April 17, 1934). In enacting Section 10(b), Congress intended to ensure fairness in securities transactions generally, whether conducted in the organized securities markets or face-to-face. *Superintendent of Insurance, supra*, 404 U.S. at 10.

In order to fulfill these Congressional objectives, the courts have repeatedly rejected restrictive readings of Rule 10b-5. For example, proof of a substantive violation of Section 10(b) and Rule 10b-5 does not depend upon proof of an actual purchase or sale of a security. In *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-855 (C.A. 2), certiorari denied *sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976, the court held that deceptive public statements, negligently made, that might generally affect securities transactions, violate Rule 10b-5. Nor must the Commission, in its own actions, demonstrate that any persons have suffered injury because of a purchase or sale; it need show only that the forbidden deceptive practices have been committed. *Hughes* v. *Securities and Exchange Commission*, 174 F.2d 969, 974 (C.A.D.C.). See also *Berko* v. *Securities and Exchange Commission*, 316 F.2d 137, 143 (C.A. 2); *N. Sims Organ & Co., Inc.* v. *Securities and Exchange Commission*, 293 F.2d 78, 80, n. 3 (C.A. 2). Cf. *Kuehnert* v. *Texstar Corp.*, 412 F.2d 700, 704 (C.A. 5), in which the court stated that it was not convinced that there was any difference in substance between a successful fraud and an attempt, since the statutory phrase " 'any manipulative or deceptive device' * * * seem[ed] broad enough to encompass conduct irrespective of its outcome."

The Court of Appeals for the Second Circuit has aptly noted that material facts that must be fully disclosed if the standard of Rule 10b-5 is to be met include those "which may affect the desire of investors to buy, sell, or hold the company's securities." *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 849. Consistent with this view is *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 594-595 (C.A. 2), which applied Rule 10b-5 to misleading statements and omissions that had induced a broker's customer to hold his stock rather than to sell it in the face of a declining market. In administrative proceedings the Commission has repeatedly taken the position that a person violates the Rule by misleading an investor not to sell.[22]



Because—if the assertions in respondent's complaint are correct—there has been a violation by petitioners of the Act and Rule, the question open for decision is whether that violation can be redressed by a private plaintiff.

### B. There Is an Implied Civil Remedy on Behalf of All Persons Injured by Violations of Rule 10b-5, Including Those Who Have Neither Purchased Nor Sold Securities

The limitation on standing imposed by the *Birnbaum* rule is inconsistent with the decisions of this and other courts that have implied causes of action for violations of the securities acts' prohibitions in order to provide redress to persons for whose protection those prohibitions were adopted.

Although Section 10(b) and Rule 10b-5 do not expressly provide a civil remedy to the victims of proscribed behavior, this Court has recognized an implied

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[22] See, *e.g.*, *Investors Management Co., Inc.*, Securities Exchange Act Release No. 9267 (July 29, 1971), pp. 9-10; *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 8459 (November 25, 1968), p. 5.

right of action under their provisions. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*, 404 U.S. at 13 n.9; *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. at 151.[23] These two decisions reflect this Court's repeated admonition that the federal securities laws, "enacted for the purpose of avoiding frauds," must be construed "not technically and respectively, but flexibly to effectuate [their] remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (Investment Advisers Act). In *Tcherepnin* v. *Knight*, 389 U.S. 332, 336, this principle was applied to the Securities Exchange Act generally; and in *Superintendent*, *supra*, 404 U.S. at 12, and *Affiliated Ute Citizens*, *supra*, 406 U.S. at 151, this Court recognized that damages could be sought for violations of Section 10(b) and Rule 10b-5.

A private right of action under Rule 10b-5 reflects this Court's recognition that "[p]rivate enforcement * * * provides a necessary supplement to Commission action." *J.I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 432. Accordingly, this Court in *Borak* directed "the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded." *Id.* at 433. It continued:

[23] The Courts of Appeals have long recognized an implied right of action under Rule 10b-5. See, *e.g.*, *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (C.A. 2); *Fratt* v. *Robinson*, 203 F.2d 627 (C.A. 9); *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195; cf. *Slavin* v. *Germantown Fire Insurance Co.*, 174 F.2d 799, 805-806 (C.A. 3) (*dictum*).



> And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.

It then held that Section 27 of the Securities Exchange Act provided such a "general right to sue" because it "grants the District Courts jurisdiction 'of all suits in equity and actions at law brought to enforce any liability or duty created by this title.'" *Ibid.*

*Borak* and this Court's more recent cases apply to the Securities Exchange Act the principle, applied in other areas of the law, that the touchstone for determining whether particular persons may maintain a civil action to redress a violation of a statutory prohibition or obligation is whether their interest "fell within the class that the statute was intended to protect" and whether "the harm that had occurred was of the type that the statute was intended to forestall." *Wyandotte Transportation Co.* v. *United States*, 389 U.S. 191, 202.[24]

This was the principle recognized and applied in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa.), the first judicial decision holding that there is an implied right of action under Rule 10b-5. There the plaintiff's standing to seek relief was upheld because the plaintiff was within the class of persons

[24] See also *United States* v. *Students Challenging Regulatory Agency Procedures*, 412 U.S. 669, 686; *Sierra Club* v. *Morton*, 405 U.S. 727, 733; *Association of Data Processing Organizations, Inc.* v. *Camp*, 397 U.S. 150, 152-153. Cf. *Flast* v. *Cohen*, 392 U.S. 83; *Hardin* v. *Kentucky Utilities Co.*, 390 U.S. 1.

"for whose special benefit the statute was enacted." [25]

More recently, the Court of Appeals for the Seventh Circuit in *Eason* v. *General Motors Acceptance Corp.*, 490 F.2d 654, certiorari denied, 416 U.S. 960, correctly perceived that the opinions of this Court "fairly imply that the rule [10b-5] was intended to protect a broader class of persons" than only purchasers and sellers of securities. 490 F.2d at 659. Because the plaintiffs in that case "were members of the class for whose special benefit Rule 10b-5 was adopted," *id.* at 658, they were held to have standing to seek damages for their alleged injuries, although they were neither purchasers nor sellers of securities.

A primary purpose of Rule 10b-5 is to protect *all* persons, not merely persons who may have purchased or sold securities, against making investment decisions on the basis of misleading or inaccurate information. In prohibiting misleading or deceptive practices that operate as a fraud upon "any person," it prohibits such practices where their tendency is improperly to discourage action no less than when their

[25] *Kardon* based its decision on 2 Restatement of Torts, Sec. 286, which provided:

> The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if: (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) *the interest invaded is one which the enactment is intended to protect* * * * [emphasis added].

See also *Fratt* v. *Robinson, supra,* 203 F.2d at 631; *Fischman* v. *Raytheon Mfg. Co., supra,* 188 F.2d at 787, n. 4; *Hooper* v. *Mountain States Securities Corp., supra,* 282 F.2d at 201.



tendency is to encourage unwarranted action. Indeed, in *Superintendent of Insurance, supra,* 404 U.S. at 12, the Court observed that among those Congress sought to protect from the impact of fraud were persons who were the creditors of corporations that may have been misled into buying or selling securities.[26] *A fortiori,* persons making investment decisions, including the decision not to purchase or sell, are within the scope of the Act, and should (under the *Borak* and *Wyandotte* principle) be able to recover damages.

Consistently with the principles supporting a private cause of action, the courts generally have recognized that a person who has neither purchased nor sold securities nevertheless is entitled to the protection of Rule 10b-5, and therefore can obtain equitable relief with respect to an alleged Rule 10b-5 violation. *Kahan* v. *Rosenstiel,* 424 F. 2d 161 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan,* 398 U.S. 950; *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F. 2d 540, 546-547 (C.A. 2); *Britt* v. *Cyril Bath Co.,* 417 F. 2d 433 (C.A. 6). In light of these decisions, some of which have been rendered by the same courts that adhere to the *Birnbaum* rule, it is

[26] Situations where individuals are injured by the investment decisions of others include that involved in *Vine* v. *Beneficial Finance Co.,* 374 F.2d 627 (C.A. 2), certiorari denied, 389 U.S. 970, in which so many of plaintiff's fellow shareholders accepted a tender offer (which was misleading, in violation of Rule 10b-5) that the acquiring corporation was able to effect a merger, causing plaintiff injury. The *Vine* court permitted recovery, and reconciled its holding with the *Birnbaum* doctrine by deeming the merger to be a "forced sale" of the plaintiff's securities.

significant that in *Borak* this Court expressly rejected a contention that the private right of action for violation of the antifraud provisions of proxy Rule 14a-9(a)[27] should be "limited to prospective relief," and held that the remedial objectives of the Securities Exchange Act required that a private right of action for damages also be recognized.[28]

The Court observed in *Borak* that to limit "victims of deceptive proxy statements" to prospective relief under the federal statute would relegate them to state court monetary remedies, and if these proved inadequate, "the whole purpose of the section [14(a)] might be frustrated." 377 U.S. at 434-435. Moreover, building upon these principles, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, rejected an interpretation that would have "[insulated] from private redress an entire category of proxy violations * * *," holding that "such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders." 396 U.S. at 382.

The same reasoning applies to the scope of Rule 10b-5 and the remedies available under it. "[T]here

[27] The language of Rule 14a-9(a) is substantially similar to the language of Rule 10b-5(b).

[28] Based upon the "purpose of § 14(a) * * * to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation," 377 U.S. at 431, and the language of Section 14(a), which, like Section 10(b), authorizes the adoption of rules "in the public interest *or for the protection of investors*," 377 U.S. at 432 (emphasis by the Court), the Court recognized "the availability of judicial relief where necessary to achieve that result." 377 U.S. at 432.



is no reason to emasculate the securities laws by forbidding remedies which might prove to be essential. Cf. *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964)." *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 463. If the rule is to be effective in accomplishing its objective of preventing fraud relating to securities transactions, the right of the victims of such fraud to maintain a private suit based upon their negative actions must encompass damages as well as injunctive relief.[29] As the Court

[29] Commentators have concluded that the *Birnbaum* decision was not dictated by the express language of Section 10(b) or Rule 10b-5. They also note that *Birnbaum* has encouraged mechanical application of a purchaser-seller requirement, producing results contrary to the purposes for which that legislation was enacted—to protect the public from the effects of fraudulent representations about securities. See, *e.g.*, Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 Mich. L. Rev. 1398, 1412 (1974); Note, *Standing to Sue in 10b-5 Actions: Eason* v. *GMAC and Its Impact on the Birnbaum Doctrine*, 49 Notre Dame Lawyer 1131, 1146-1147 (1974); Comment, *Inroads on the Necessity for a Consummated Purchase or Sale under Rule 10b-5*, 1969 Duke L.J. 349 (1969); Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing under Rule 10b-5*, 56 Geo. L.J. 1177, 1178 (1968); Note, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, 53 Cornell L. Rev. 684, 698 (1968); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 Va. L. Rev. 268, 275-276 (1968); see also, Jacobs, *Birnbaum in Flux: Significant 10b-5 Developments*, 2 Sec. Reg. L.J. 305 (1975); 27 Vand. L. Rev. 572 (1974); Leech, *Transactions in Corporate Control*, 104 U. Pa. L. Rev. 725, 774 (1956); Comment, *The Decline of the Purchaser-Seller Requirement of Rule 10b-5*, 14 Vill. L. Rev. 499, 501-502 (1969); Note, *Fiduciary Suits Under Rule 10b-5*, 1968 Duke L.J. 791, 807-808; Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U. L. Rev. 541,

of Appeals for the Seventh Circuit observed in *Eason*, *supra*, 490 F.2d at 659, the purchaser-seller limitation

> is not consistent with the overriding requirement that, in construing the 1934 Act, "form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin* v. *Knight*, 389 U.S. 332, 336.

**C. This Court Should Not Adopt the *Birnbaum* Rule as a Method to Limit the Class of Potential Plaintiffs**

Petitioners express concern (Pet. Br. 34) that the decision of the court of appeals would allow anyone who had not purchased securities which were offered to him to bring an action simply by claiming that he would have purchased the securities, if the offeror had disclosed additional facts from which he might have inferred that the securities were worth more than the offering price.[30] We agree with petitioners that the effect, if any, of a deceptive prac-

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545 (1968); Note, *Civil Liability Under Rule X-10b-5*, 42 Va. L. Rev. 537, 570-571 (1956); Ruder, *Current Developments In The Federal Law of Corporate Fiduciary Relations —Standing to Sue Under Rule 10b-5*, 26 Bus. Law. 1289 (1971).

[30] Of course, frivolous suits can be brought whatever the rules of standing; it is necessary only for a determined plaintiff to plead words consistent with applicable standing requirements, even though he knows that he cannot succeed on the merits. Opportunities for vexatious litigation will abound whether or not the *Birnbaum* rule is adopted. As this Court has recognized in a different context, "the expense and annoyance of litigation is 'part of the social burden of living under government'." *Petroleum Exploration, Inc.* v. *Public Service Commission*, 304 U.S. 209, 222.



tice on someone who has neither purchased nor sold securities may be more difficult to demonstrate than is the effect on a purchaser or seller. In either case the plaintiff must demonstrate some relationship between the alleged deceptive practice and his injury. If, as here, that injury resulted from his own "non-action," he also must demonstrate that his failure to act was caused by the defendant's activities. But this additional problem of proof can be ameliorated by devices more consistent with the purposes of the securities laws.

In *Affiliated Ute Citizens, supra*, Indians sought relief under Rule 10b-5 against bankers who sought their shares in the course of encouraging a market for shares among non-Indians. This Court held that if there was a direct relationship between the Indians and the bankers, and the bankers omitted to state facts that a reasonable investor might have considered important in the making of his investment decision, a causal connection between the wrongful omission and the plaintiffs' injuries would be presumed. This presumption might apply in many cases involving potential investors. In other cases, however, it might be unreasonable for the courts to make such a presumption and, indeed, where only a tenuous relationship exists, it might be appropriate (in order to prevent abuses) to impose upon the plaintiffs a heavier burden of proof than would normally be applicable. It might be necessary, for example, for a plaintiff who has neither purchased nor

sold securities to offer corroborative evidence which, independent of his own testimony, tends to show that the plaintiff's investment decision was directly affected by the deceptive device (or that the violation caused him injury in some other way) and that he was within the class of persons for whose benefit the rule was adopted.[31]

Thus, contrary to petitioners' argument, a decision by this Court not to adopt the *Birnbaum* rule would not require submitting to the finders of fact every suit in which someone claimed that "but for" a public statement by the defendant the plaintiff would have acquired or would have sold securities. In fact, there would be few situations where plaintiffs could demonstrate a nexus between a wrongful act and an alleged injury sufficient to permit submission of the case to the jury, if that plaintiff were not the owner of securities or a person to whom an offer to buy or sell had been directed.

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[31] In the instant case, the direct relationship that is alleged to have existed between the plaintiff and the defendants seems sufficient to warrant the presumption permitted by *Affiliated Ute Citizens*. In any event, respondent's reliance upon the defendants' alleged deceptive practices is corroborated by the consent judgment in the antitrust action and by respondent's receipt of the misleading prospectus. It is reasonable to believe that respondent was actively considering a purchase of Blue Chip Stamps' securities, and that the representations in the prospectus were material to this decision. That should be sufficient objective indicia, particularly if a plaintiff can show, as respondent alleged here, that there was a plausible reason why the issuer of the shares would be motivated to make representations that would deter the plaintiff from acting.



Moreover, even where a proper nexus has been established, the fact that liability may be imposed upon individual wrongdoers does not require that a damage remedy must necessarily be recognized to the same extent against the corporations for which they work, if broad vicarious liability would conflict with the objectives of the federal securities laws. Although there are strong public policies that militate in favor of imposing liability upon a corporation for the acts of its officers and authorized agents, a court may well be concerned that the wrongful acts of officers in violations of Rule 10b-5 not expose the shareholders of a publicly-owned corporation to undue liability. Of course no reason exists, either in equity or in the objectives of the federal securities laws, to permit a corporation to retain profits or any other forms of benefits it may have derived from the wrongful acts of its officers or agents.[32] But where the corporation has not benefited, the courts may find it equitable, and consistent with the basis upon which

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[32] Since the *Birnbaum* rule may, in some situations, protect corporations from liability even to the extent of profits that can be traced to violations of the law, its rejection may impose additional costs on some companies. Judge Hufstedler's analysis in dissent below seems implicitly to assume that there is or may be widespread non-compliance with Rule 10b-5. If this is so, any increased costs that would result from allowing suit are the costs of compliance with the Rule, and long since should have been paid. The securities laws as a whole reflect a congressional judgment that the benefits to be derived from full disclosure of material facts outweigh the economic costs that disclosure entails.

a right of action has been implied under Rule 10b-5, to limit an award of damages against it.[33]

Nor is the arbitrary rule of "standing" advanced by petitioners essential to protect the "common method of distributing new securities * * *" (Pet. Br. 28). The case at bar is not the "typical securities transaction" described by petitioners (Pet. Br. 28-30); typically the issuer and underwriter seek to sell the securities as promptly as possible, and rarely if ever would make them appear unattractive through inadvertence or otherwise.

The *Birnbaum* rule does not produce a conflict between the registration requirements of the Securities Act and the antifraud provisions of the Securities Exchange Act, as petitioners suggest (Pet. Br. 36-42). To be sure, compliance with the registration requirements of the Securities Act assumes that proper emphasis be given to risk factors by persons who seek to sell securities to the public. In this context there may be a tendency to overstate risks, because it is doubtful that any court would find it appropriate to impose liability upon an offerer who tends somewhat to understate the merits of the securities he is honestly trying to sell, so long as no truly material falsehood or omission is involved.[34]

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[33] Cf. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (C.A. 2).

[34] The concept of materiality (see, *e.g.*, *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (C.A. 2) (*en banc*), certiorari denied, 394 U.S. 976) eliminates the possibility that the most minute mistake will lead to liability. Thus, offerers are not required to be "micrometrically accurate," as Judge Hufstedler seems to fear (App. 151, n. 8.).



But where, as is alleged here, the sale of stock was contrary to the petitioners' self-interest, any overstatement of the risks should not be viewed charitably. Fraud in the offer of securities is a violation of Section 17(a) of the Securities Act, as well as a violation of Rule 10b-5 under the Securities Exchange Act, and, as we have seen (pp. 8-17, *supra*), the *Birnbaum* rule adds nothing to a registrant's substantive legal duty. It relates only to a plaintiff's ability to recover for injuries.[35]

Petitioners also argue (Pet. Br. 34-35) that the availability of the class-action procedure, a device designed to permit vindication of just claims that might be too small to pursue individually, and this Court's recognition that a causal relationship between wrongful acts and resultant injury may be inferred from the materiality of undisclosed facts, are reasons to deny standing. But this really is a complaint that remedies for violation of the Rule will work too well.

Throughout their brief (particularly at pp. 32-33) petitioners also stress that respondent was not an

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[35] Thus, the alleged conflict is irrelevant to the question of standing, since petitioners' argument goes to the merits of plaintiff's claim that Rule 10b-5 has been violated, rather than to the threshhold question of who may bring suit to test those merits. If the petitioners can show that their discouraging statements concerning Blue Chips Stamps' prospects were justified, consistent with the conservative philosophy of the Securities Act registration requirements, they may prevail on the merits. But the possibility that they may have a good defense is no reason to deny a plaintiff its day in court.

"investor." [36] We submit that this is irrelevant. The essence of respondent's complaint is that petitioners fraudulently induced the offerees to refrain from investing; it would be most anomalous if the defendants' success in preventing an investment—the very fraud that gives rise to the claim for relief—should be viewed as a reason why the alleged victims should not even be heard on the merits of their claim.

Finally, petitioners suggest that it would be unfair to those who have invested in particular securities were a court to permit "those who have never invested in, or made a legal commitment to the offered securities," to "seek the profit they allegedly could have made had they accepted the offer, entered into the transaction and put their funds at risk" and then be "paid out of the pocket of the company with which those who bought risked their funds." (Pet. Br. 32-33). But this analysis, whatever its merits, does not support the *Birnbaum* rule.

Comparable situations exist even where the *Birnbaum* rule permits suit. For example, a similar no-risk-therefore-no-suit argument can be made where a person has been fraudulently induced to sell (thus ending his "risk") while other non-selling investors continued to risk their capital. The *Birnbaum* rule would not preclude these sellers, in effect, from having a call on stock without having been subjected to

[36] On this basis petitioners (Pet. Br. 20) purport to distinguish *Eason* v. *General Motors Acceptance Corp.*, *supra*, which expressly rejected the purchaser-seller requirement. See pp. 9 n.5, 24, *supra*.



the risk borne by those who had not been deceived into selling.[37] At the same time the *Birnbaum* rule bars suit by an investor who *has* put his funds at risk but who is fraudulently dissuaded from selling shares he already owns.

The *Birnbaum* purchaser-seller requirement simply is not a doctrine placing "reasonable limits on the broad exposure to damage liability that has developed under the section and rule" (Pet. Br. 23). The "limits" imposed by the *Birnbaum* rule are artificial and arbitrary; it denies standing—without regard to defendants' culpability or plaintiffs' ability to prove their claims—to a class of persons for whose protection the statute was enacted.

The *Birnbaum* rule itself has provoked substantial litigation concerning its scope and exceptions. At least in recent years courts that have concluded from the pleadings that a plaintiff might have a meritorious claim have been willing to devise interpretations and exceptions to the *Birnbaum* rule that emphasize the artificial nature of that rule. Compare *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (C.A. 2); *Greenstein* v. *Paul*, 400 F.2d 580 (C.A. 2); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355 (C.A. 2), reversed, 404 U.S. 6, and *Drachman* v. *Harvey*, 453 F.2d 722

[37] Any inequity in both these situations can be adjusted through judicious allocations of damages appropriate to the particular case. Cf. *J. I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 433-435.

(C.A. 2), reversed on rehearing *en banc*, 453 F.2d 736, with *International Controls Corp.* v. *Vesco*, 490 F.2d 1334 (C.A. 2), certiorari denied, 417 U.S. 932; *James* v. *Gerber Products Co.*, 483 F.2d 944 (C.A. 6); *Travis* v. *Anthes Imperial Ltd.*, 473 F.2d 515 (C.A. 8); *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787 (C.A. 2), certiorari denied, 400 U.S. 822; *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (C.A. 2), certiorari denied, 389 U.S. 970; *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (C.A. 2); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F.2d 540 (C.A. 2), and *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (C.A. 2).

The existing exceptions to the *Birnbaum* rule allow some individuals who neither purchased nor sold securities to bring suit, and so already permit the vexatious litigation petitioners fear. Others may sue in the hope of creating additional exceptions to the rule. Litigation over these exceptions can be protracted and costly, as the instant case demonstrates. Indeed, the combined social costs of strike suits falling within the current exceptions and the costs of litigation determining the existence and scope of these exceptions may exceed whatever costs might be incurred from allowing standing to all persons within the class protected by Rule 10b-5 who allege they have been injured by a defendant's violation of it.

We submit that the equitable limitation on vicarious liability for damages we have suggested above, together with appropriate burden-of-proof requirements, will sufficiently protect all of the legitimate interests of petitioners and other offerors of securities. This Court should not go further and adopt a rule of standing that places an arbitrary obstacle to recovery in the path of innocent victims and serves primarily to protect violators of the rule.



## CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed on the ground that no "purchaser-seller limitation" is applicable to a private cause of action pursuant to Section 10(b) of the Securities Exchange Act and Rule 10b-5.

Respectfully submitted.

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